



# **VENDOR FRAUD:**

## *Detection and Prevention Tools and Techniques*

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***Breakout Session 1***  
***VENDOR FRAUD: Detection and***  
***Prevention Tools and Techniques***

E • C • I

Economic Crime Institute

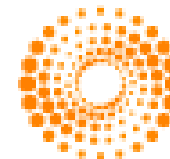
**Economic Crime Council**

# Headline News ...

## Two Commissioners Convicted in \$1.4 Million Bribery and Kickback Scheme ...

**VIRGIN ISLANDS, September 3, 2008** - A federal jury in St. Thomas found the former Commissioner of the U.S. Virgin Islands Department of Planning and Natural Resources guilty of demanding and accepting bribes and obstructing justice and the former Department of Property and Procurement guilty of demanding and accepting bribes in a \$1.4 million bribery and kickback scheme.

- Awarded government 7 contracts in over 3 years
- 2 week trial
- 12 count indictments



**REUTERS**

# Headline News ...

## Grand Jury Indicts Former Memphis City Schools Employee, Vendor for Theft over \$60,000 ...

**MEMPHIS, September 8, 2008** - The Shelby County Grand Jury indicted a former Memphis City Schools employee and a the owner of a motor repair shop for allegedly stealing thousands of dollars from the city school system. Randal Taylor and Clyde Green were charged with theft of property over \$60,000.

- Taylor used position at MCS to award a contract to Green
- Green paid Taylor a kickback of \$15,000
- The two face 12 years and large fines



# Headline News ...

## Two El Paso Businessmen and Their Companies Charged with Conspiracy to Rig Bids

**EL PASO, September 10, 2008** – A Federal grand jury returned an indictment today, charging the CEOs of Architectural Products Company, Inc., and El Paso Steel Doors and Frames, Inc., with conspiracy to rig bids and allocate customers for certain contracts to supply and install doors and hardware for area construction projects. One of the individuals was also charged with obstruction of justice for his efforts to impede the federal grand jury investigation.

- Lindsay Holt and Humberto Lopez
- They face:
  - 10 years in prison
  - \$1 million fine



# Headline News ...

## Corruption & Fraud Charges Announced Against President Jacob Zuma

**SOUTH AFRICA, September 12, 2008** - African National Congress (ANC) President Jacob Zuma, carries an AK-47 rifle outside the Pietermaritzburg High Court, South Africa, today. Judge Chris Nicholson recently announced fraud, corruption and money laundering charges against Zuma relating to massive purchasing scandal.



Jacob Zuma

# In this Session, you will learn ...

- ▶ Introduction
  - Fraud Basics
  - Red Flags for:
    - Lone Vendor
    - Employee-Fraudster
- ▶ Vendor Fraud Schemes
  - External
  - Internal
- ▶ Bribery - Corruption – Gratuities
- ▶ Looking for the Evidence
- ▶ Fraud Prevention Techniques
  - Right to Audit and other Legal Issues
  - Keeping Vendors Honest





# **VENDOR FRAUD:**

## ***Detection and Prevention Tools and Techniques***

### **Introduction**

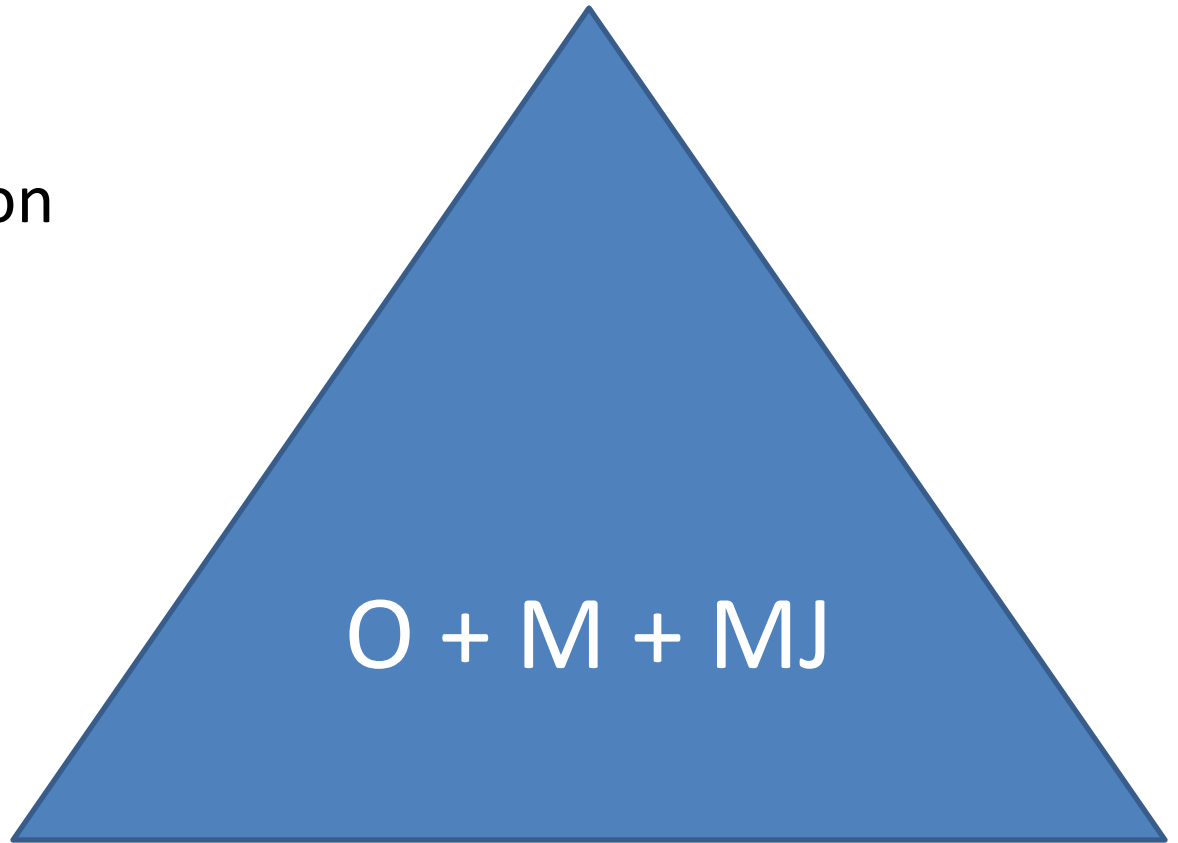
**R. A. (Andy) Wilson, CFE, CPP**

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# The Fraud Triangle

- ▶ Opportunity
- ▶ Motivation
- ▶ Moral Justification



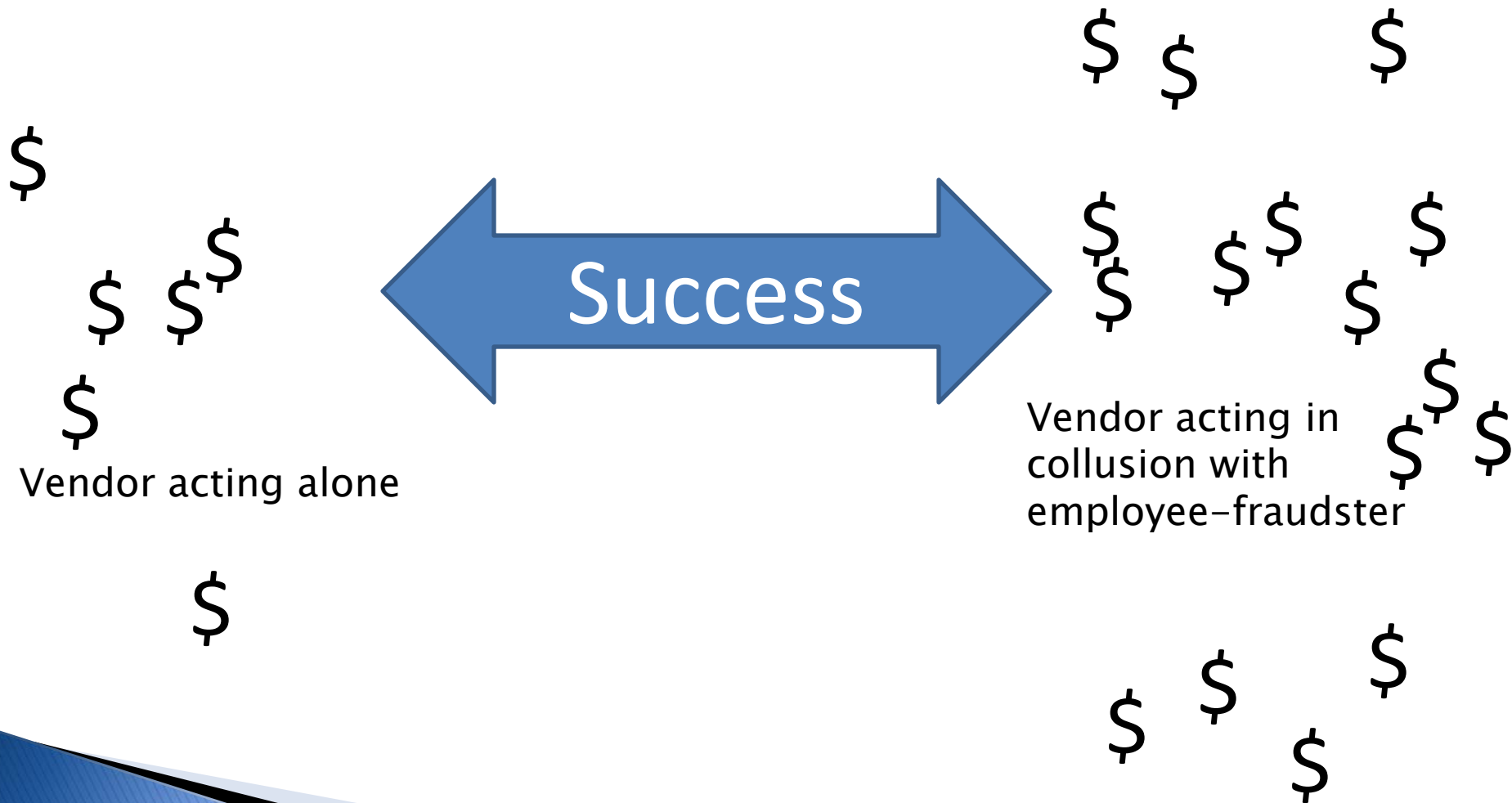
# In general, fraud ...

- ▶ Organizations lose 7% of their annual revenues to fraud
  - Applied to the projected 2008 U.S. Gross Domestic Product, the figure translates to approximately \$994 billion in fraud losses
- ▶ Schemes are very costly, most last 2 or more years
- ▶ Many categories of fraud:
  - Corruption occurred 27% of the time
  - Fraudulent billing occurred 24% of the time
- ▶ Even with the focus of anti-fraud controls, via SOX, SAS 99, tips are the most common form of detection, over audit, controls and management supervision

# In general, fraud ...

- ▶ The implementation of anti-fraud controls:
  - Does have an impact on the organization
  - Controls significantly impacted the organizations profits
- ▶ The lack of controls is the most common factor that allowed fraud to occur
- ▶ Three out of four organizations modify their anti-fraud controls after being victimized
- ▶ Common behavior signs of employee-fraudsters are:
  - Living above ones means (39%)
  - Experiencing financial difficulty (34%)

# Vendor fraud schemes ...



# Red flags of Employee-fraudster ...

- ▶ Unusually high personal debts
- ▶ Personal financial losses
- ▶ Living beyond ones means
- ▶ Involvement in speculative investments
- ▶ Alcohol problems
- ▶ Drug problems
- ▶ Family or peer pressure
- ▶ Feelings of being under paid
- ▶ Job dissatisfaction
- ▶ Insufficient recognition for job performance
- ▶ Continues to threaten to quit job
- ▶ Overwhelming desire for personal gain
- ▶ Close association with
  - ▶ Suppliers
  - ▶ Customers
- ▶ Wheeler-dealer attitude
- ▶ Rationalizes poor performance

# Motivating factors of the Employee-fraudster ...

- ▶ Living beyond ones means
- ▶ Overwhelming desire for personal gain
- ▶ High personal debt
- ▶ Close association with customers
- ▶ Feeling that pay is not commensurate with responsibility
- ▶ A wheeler-dealer attitude
- ▶ Strong challenge to beat the system
- ▶ Excessive gambling habits
- ▶ Undue family or peer pressure
- ▶ No recognition of job performance



# **VENDOR FRAUD:**

## ***Detection and Prevention Tools and Techniques***

### **Vendor Fraud Schemes**

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# Vendor fraud ...

- ▶ Continues to be a leading concern for security and risk management professionals
  - Difficult to detect
  - Occurs over long periods of time
  - Increasing the magnitude of the fraud
- ▶ Vendors are defined as anyone that you or your company pays for goods or services
  - Suppliers
  - Contractors
  - Employees
  - Charities

**Leading Concern!**

**Who are Vendors?**

# Two billing scheme methods ...

- ▶ Inflated Prices
- ▶ Substitution
- ▶ False Billing
- ▶ Multiple Billing
- ▶ Shell
- ▶ Pass-Through
- ▶ Pay & Return
- ▶ Personal Purchase

**External Schemes**

**Internal Schemes**

# Inflated Prices Scheme ...

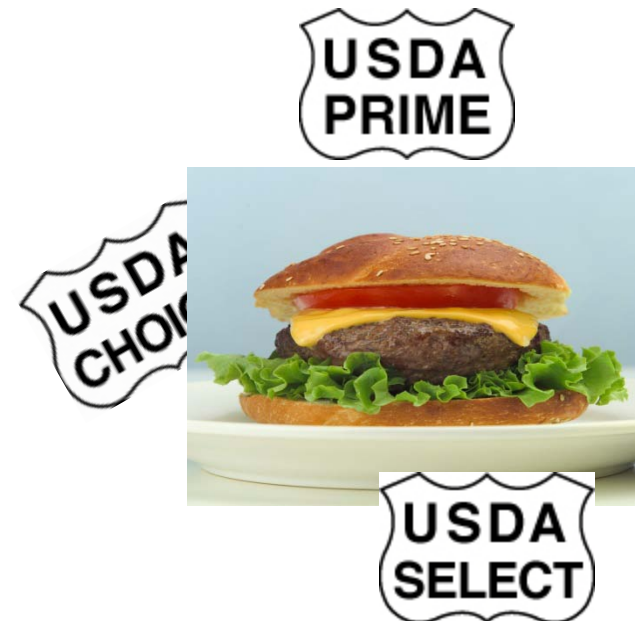
- ▶ Inflate prices
  - List at a rate “clearly above” the market rate
- ▶ Mortgage
  - Drive-by appraisals
  - Inflated loans amounts
    - Free car
    - Free swimming pool
- ▶ Any products or services
  - Attorney billing
  - Service repair billing



Mortgage Appraisal Schemes

# Substitution Scheme ...

- ▶ Substitute inferior quality of goods or services than were actually ordered
  - Grocery items
    - Produce
    - Meat
  - Building materials
  - Other items
- ▶ Bill for the higher quality



# False Billing Scheme ...

- ▶ Bill for services not performed or delivered
  - Nice looking invoice for goods or services
  - Mailed to thousands (game of numbers)
  - Hope your company will process and pay without scrutiny
- ▶ Common types:
  - Minority organizations
  - Useless business directories
  - Internet directories



# Example of False Billing Scheme ...

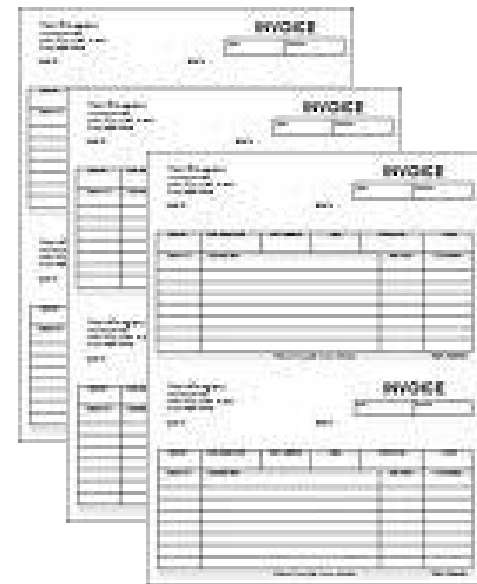
- ▶ Telephone solicitation, looking for
  - Name of individual
  - Model and type of copy machine
- ▶ Supplier in distress (going out of business)
  - Discount prices
- ▶ Follow-up to cash-in
  - Your company placed order, but no invoice sent
  - Product sent to other company site
- ▶ No catalog
- ▶ Pressure



Copy Machine Supplies Scam

# Multiple Billing Scheme ...

- ▶ Issue multiple billings for the same goods or services
  - Variation on Invoice numbers
  - Billing spread over several billing cycles



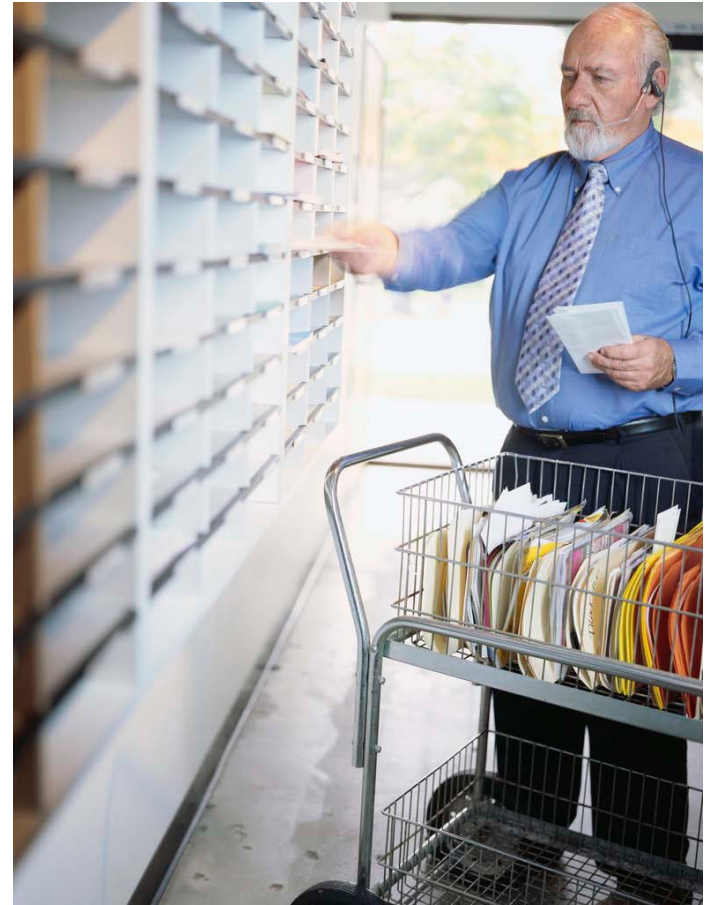
# Shell Company Scheme ...

- ▶ The employee-fraudster:
  - Uses a fake entity to bill a company for goods or services it does not receive
  - Converts the payment to his or her own benefit



# Pass-Through Scheme ...

- ▶ The employee-fraudster:
  - Uses a shell company established by the employee to purchase goods or services
  - Which are then marked-up and sold to the employer through the shell
  - Converts the mark-up to his or her own benefit



# Pay & Return Scheme ...

- ▶ The employee-fraudster:
  - Purposely caused an overpayment to a legitimate vendor
  - Contacts the vendor to explain the error
    - Asks that the refund be directed specifically to the employee-fraudster
    - Converts to personal gain



# Personal Purchase Scheme ...

- ▶ The employee-fraudster:
  - Orders personal merchandise
  - Charges it to the company
    - Merchandise:
      - Kept
      - Returned



# Signs of Fraud ...

- ▶ Invoices for:
  - Unspecified consulting
  - Poorly defined services
- ▶ Invoices that are broken into multiple smaller invoices, each for an amount that will not attract attention (Invoice splitting)
- ▶ Internal control deficiencies:
  - Allowing a person who processes payments to approve new vendors (limited or no segregation of duties)
- ▶ Unfamiliar vendors
- ▶ Vendors:
  - Only a post-office-box address
  - Company names consisting only of initials (many are legitimate, but crooks commonly use this naming convention)
- ▶ Rapidly increasing purchases from one vendor
- ▶ Vendor billings more than once a month
- ▶ Vendor addresses that match employee addresses

**Invoices & Controls**

**Vendor Alerts**



# **VENDOR FRAUD:**

## ***Detection and Prevention Tools and Techniques***

**Bribery - Kickbacks - Gratuities**

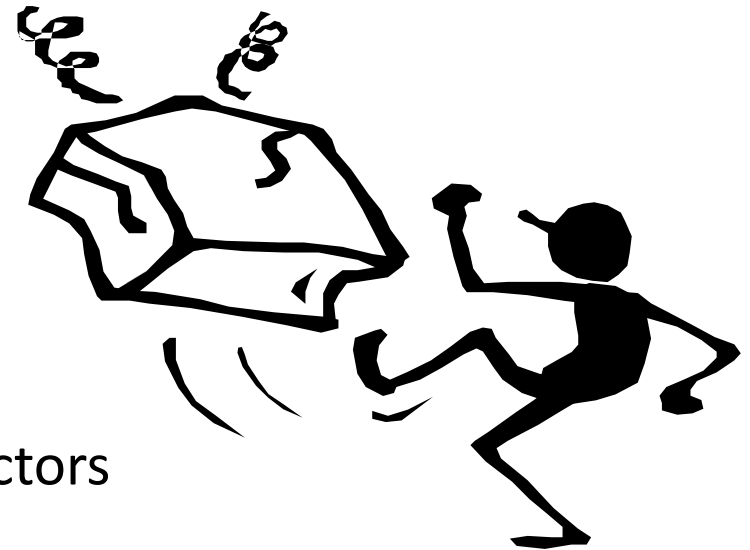
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# These schemes are ...

- ▶ Off book frauds
  - Kickbacks
  - Gifts
  - Other
- ▶ Given to:
  - Government employees by contractors
  - Private companies by vendors
- ▶ Relates to:
  - The purchasing function by the government or private companies. Illegal benefits to an employee-fraudster for the favorable purchase of goods or services



# Bribery – Kickbacks – Gratuities

- ▶ Giving or receiving anything of value to influence a business decision, without the employer's knowledge and consent
- ▶ Submission of invoices for goods or services:
  - Overpriced; or
  - Completely fictitious
- ▶ Vendor submits the fraudulent or inflated invoice and the employee helps to insure the payment is made
  - For his assistance, the employee receives a payment from the vendor
  - The event is a crime even if the money does not exchange hands
- ▶ This payment is a kickback!

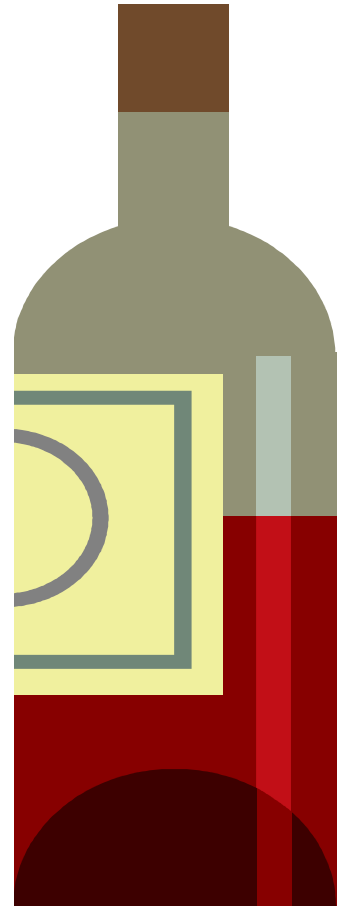
# Illegal Payment Methods

- ▶ Last over extended periods of time
- ▶ Payments:
  - Start small (i.e. favors, then gifts, travel & entertainment)
  - Grows larger as the scheme progresses
    - Favors to “cold hard cash!”
  - Eventually:
    - Quid pro quo for specific deals



# Gifts, Travel & Entertainment

- ▶ Starts small and grows larger over time
- ▶ Initially, the inducement is not for a “specific” contract or business deal, instead just to establish a “special relationship”
- ▶ Over time, these increase:
- ▶ Common inducements include”
  - Liquor, wine, etc
  - Tickets to events
  - Inventory, services
    - Construction (i.e. home improvements)
  - Travel
    - On the corporate jet
    - Vacation



# Cash/Check Payments

- ▶ Over time favors and perks turn to CA\$H ...
- ▶ Cash over checks
  - Difficulty to trace
  - Large amounts - incriminating
- ▶ Checks
  - Easier to deposit when the sums are larger
  - Books and Records
    - It might appear as a (disguised) consulting fee
  - Made directly to employee or to the shell company of the employee



# Loans

## Payment

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described as:  
an  
“innocent loan”

## Payment

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on the  
actual loan  
of the employee-  
fraudster

## Actual Loan

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loan  
made to the  
employee-  
fraudster on  
favorable  
terms

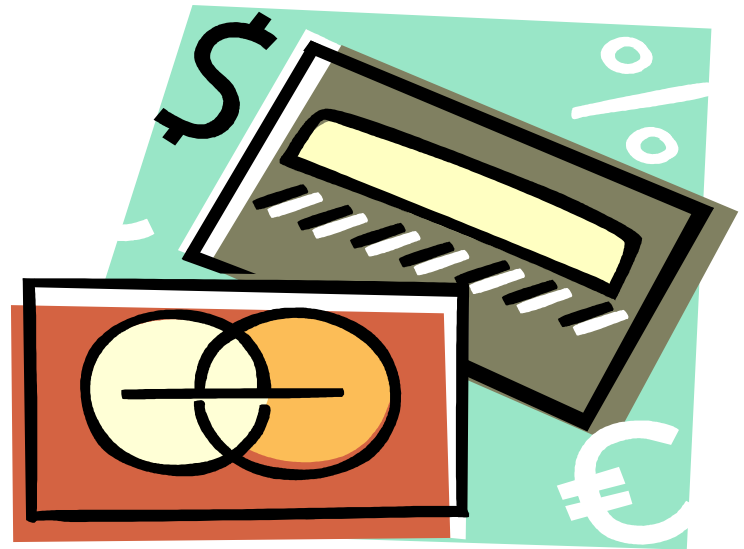
# Hidden Interests

- ▶ Gift as interest in a business, joint venture or other enterprise
- ▶ Hidden or disguised
  - Nominee (or Straw man)
  - Trust arrangement
    - Oral
    - Written
  - Other business entity



# Payments by Credit Card

- ▶ Use of the bribers credit card to pay for transportation, travel or entertainment, as well as other expenses
- ▶ Briber just issues a credit card to the employee-fraudster



# Promises for Favorable Treatment

- ▶ When you retire from the government
  - There will be a place here for you
- ▶ Executive leaving a private company for a government job
  - Given inflated retirement or separation benefits
- ▶ Spouse or other relative
  - Given job
  - Inflated salary



# Two Main Categories ...

## ▶ Kickbacks:

- Undisclosed payments made by vendors to employees-fraudsters
- These payments entice the employee to enter into a overbilling scheme

## ▶ Bid-Rigging:

- Employee-fraudsters assist a vendor in winning a contract through the competitive bidding process



# Diverting Business to Vendors

- ▶ Often begins simply as a vendor paying the employee-fraudster (often the purchasing agent), small dollars
- ▶ Develops exclusive relationship
  - No longer subject to competitive pricing
  - No longer has to offer the lowest price
- ▶ Changes to the vendor inflating the contract price (to cover the kickback) and the employee-fraudster approving the contract, then the employee-fraudster receives a payment, the kickback
- ▶ Pressure
  - Vendor now has a hook and can apply pressure and they do!



# Bid-Rigging Schemes

- ▶ The competitive process is good for the purchasing company, in that vendors bid for work on a level playing field
- ▶ This business is often cutthroat
- ▶ Sometimes vendors receive “advantages” over another, these advantages are extremely valuable to the vendor, who uses that information to gain a competitive positioning

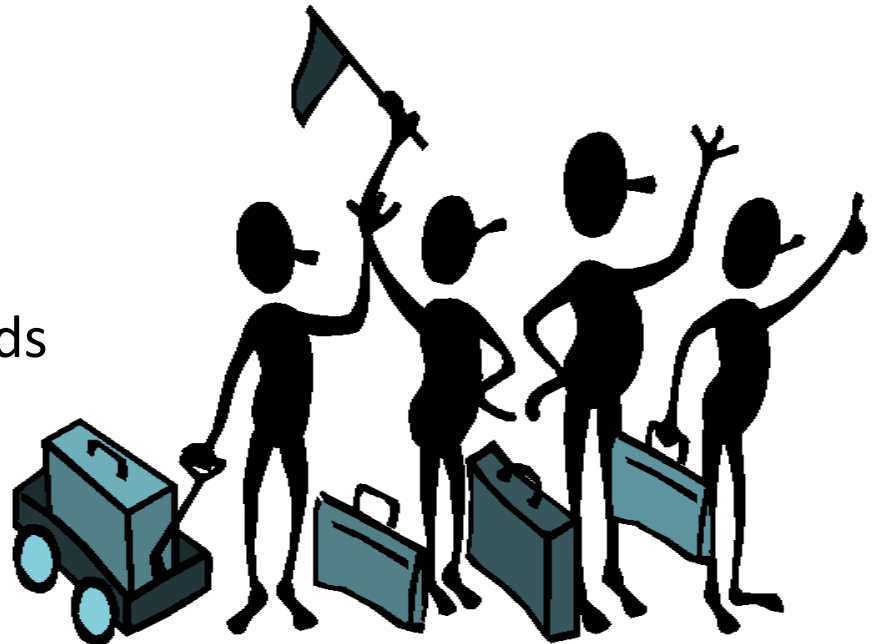


**The Competitive Process**

**Information is Valuable**

# Bid-Rigging Scheme Phases ...

- ▶ Pre-Solicitation
  - Need Recognition Schemes
  - Specifications Schemes
- ▶ Solicitation
  - Bid Pooling
  - Fictitious Suppliers
  - Destruction of Legitimate Bids
- ▶ Submission
  - Economic Extortion
  - Illegal Gratuities





# **VENDOR FRAUD:**

## ***Detection and Prevention Tools and Techniques***

**Looking for the Evidence!**

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Managing Director

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# Look for the Facts!

## ▶ Accounting Anomalies

- Irregularities in Source Documents
  - Missing documents
  - Excessive voids or credits
  - Altered documents
  - Duplicate invoices
  - Sequences that do not make sense

**Accounting Anomalies**

## ▶ Lack of:

- Segregation of duties
  - Lack of physical safeguards
  - Independent checks
  - Proper authorization
- ## ▶ Overriding of existing controls
- ## ▶ Inadequate accounting system

**Internal Control Weakness**



# More Facts & Key Observations ...

- ▶ Unexplained
    - Shortages
    - Overages
  - ▶ Deviations from purchase specifications
  - ▶ Excess purchases
  - ▶ Significant increases/decreases in inventory and balances
- ▶ Guilt-Fear-Stress
    - Insomnia
    - Excessive drinking
    - Drug use
    - Increased smoking
    - Inability to relax
    - Defensive/Argumentative
    - Belligerence

**Analytical Anomalies**

**Unusual Behavior**





# **VENDOR FRAUD:**

## ***Detection and Prevention Tools and Techniques***

**Prevention Techniques & Laws to Prosecute**

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# Right to Audit!

- ▶ Establishes your company's right to inspect vendor:
  - Invoices
  - Suppliers
  - Financial records
- ▶ To ensure that your company is not being overcharged or charged for goods or services not rendered
- ▶ Include an abbreviated version of the right-to-audit clause on every purchase order your company sends out
- ▶ Use language that's agreed upon by the:
  - Legal
  - Audit
  - Procurement Departments

**Assert your Rights**

**Spell it Out**

# Cleanse Master Vendor Files

- ▶ On an annual basis:
  - Eliminate Inactive Vendors
  - Remove Duplicate Vendors
  - Consolidate Multiple Remit to Addresses



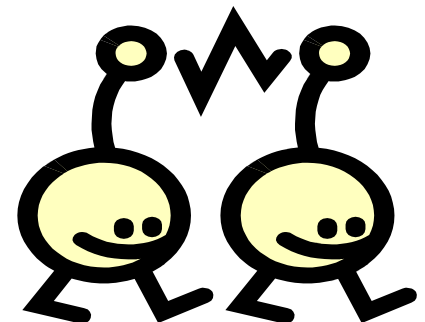
# Eliminate Inactive Vendors

- ▶ On average 50% or more of vendors on the master vendor file are inactive.
- ▶ Periodic elimination of inactive vendors will:
  - Increase processor keying speed
  - Enhance system response time
  - Reduce errors
- ▶ Recommended time frame for purging vendors with no activity is 12 months



# Remove Duplicate Vendors

- ▶ Duplicate vendors are:
  - Huge problem any organization
  - Increase the likelihood of duplicate payments
  - Create great difficulty when trying to compile spending summaries
    - IBM
    - I.B.M.
    - International Business Machines
- ▶ The vendor creation process should require a look-up function, to minimize adding redundant vendors



# Dealing with Privilege & Compliance

## ▶ Internal Investigations

- Attorney Client Privilege
  - Communications
  - Is there a special privilege?
- Work Product Privilege
  - Documents
- Electronic Discovery

## ▶ Outsourcing that impacts:

- Financial Reporting
  - SAS 70 Compliance
    - Risk Assessment
    - Audits
- Regulatory Schemes
  - Vendor Compliance
  - Liability for failure to supervise
- Information Sharing
  - Gramm-Leach-Bliley Compliance
- Constructional provisions

**Privilege**

**Compliance**

# Keeping the Vendors Honest!

- ▶ Establish and emphasize a Corporate Code of Conduct, that encourages employees to report unusual vendor behavior
- ▶ Provide training for employees, focusing on the prevention & detection of vendor fraud
- ▶ Establish a code of sanctions against vendors and supplier that engage in fraud
- ▶ Review internal controls over disbursements to confirm all expenses are authorize and supported
- ▶ Conduct background checks and screening on all vendors
- ▶ Establish and enforce staff rotation for employees who work with vendors

# Key Federal Laws ...

## ▶ Prohibits:

- Giving or receiving
- Any "thing of value"
- To a public official
- To influence
- An official act

18 USC 201

**Official Bribery**

## ▶ Prohibits:

- A U.S. person or other person in the U.S
- Giving anything of value
- Directly or Indirectly
- To foreign government officials
- To obtain business or to gain an improper advantage

15 USC 78

**Foreign Corrupt Practices Act**

# Key Federal Laws ...

## ▶ Prohibits:

- Giving or receiving
- Any “thing of value”
- To a public official
- To influence
- A business decision
- Without the knowledge and consent of the employer

½ States

**Commercial Bribery**

## ▶ Prohibits:

- Whoever, being an officer or employee of the executive branch of the U.S. Government
- Participates personally and substantially in a deal
- In which, he [or related party], has a financial interest
- Without full disclosure

18 USC 208

**Conflict of Interest**



# **VENDOR FRAUD:**

## ***Detection and Prevention Tools and Techniques***

**Questions & Answers**

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